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IN THE

# SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 196[illegible].

No. [illegible]87

MANAGED FUNDS, INCORPORATED,
Petitioner,

vs.

J. JOHN BROUK et al.,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit.

## BRIEF IN OPPOSITION

for

Respondents, Jacob Baker and George H. Shields, III.

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IN THE

# SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1960.

No. 947.

MANAGED FUNDS, INCORPORATED,
Petitioner,

vs.

J. JOHN BROUK et al.,
Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit.

## BRIEF IN OPPOSITION

for

**Respondents, Jacob Baker and George H. Shields, III.**

### OPINION BELOW.

The District Court overruled (R. 29-31) without opinion the motion of respondents Baker and Shields (R. 38[1]) and of other respondents (R. 21-24) to dismiss the complaint for want of jurisdiction of the subject matter.[2] The Court of Appeals reversed the District Court, and its opinion is reported at 286 F. 2d 901.

[1] The text of the motions of Respondents Baker and Shields was omitted from the record in the Court of Appeals because the motions were substantially similar to those filed by other respondents.

[2] The motions of Respondents Baker and Shields also raise a question of jurisdiction of the person; however, personal service was later had on Shields (but not on Baker) in the district of the district court.

## JURISDICTION.

Jurisdiction of this Court rests on 28 U. S. C. 1254 (1).

## INTRODUCTORY.

This brief, filed on behalf of certain respondents who prevailed below, seeks to persuade the Court that there is no occasion for granting certiorari.

Another brief in opposition is being filed by Respondents Brouk, Rebstock, Rice, Roberts and Mullen. With respect to the District Court's jurisdiction of the subject matter, which is the issue to which the petition for certiorari is addressed, Respondents Baker and Shields occupy precisely the same position as the Brouk group. We therefore adopt the statements and arguments made in the Brouk brief, but we wish to supplement that brief:

First, by our own formulation of the "Questions Presented";

Second, by additional argument.

## QUESTIONS PRESENTED.

We believe that the petition for certiorari inadequately states the questions presented. We submit that, correctly stated, the questions are:

A. Where a corporation's complaint states a claim[1] of director misconduct under state law, does the case become one "arising under" the laws of the United States merely because the complaint includes allega-

[1] The complaint alleges that the directors aided, abetted, and committed actual or statutory violations. No concession is intended that mere knowledge would give rise to liability, nor that plaintiff has been damaged.

tions that the directors **caused the Company to violate a federal statute**, or are those allegations "mere excrescence or superfluity tacked on to what are otherwise sufficient allegations of a claim for relief under (state) law"?[1]

B. If the question A be answered in favor of the plaintiff-petitioner, does the Investment Company Act of 1940[2] create in favor of an investment company a private right of action, against former directors who are alleged **to have caused the company** to violate the Act but who are not alleged to have personally violated any express command of the Act?

It will be observed that the Petition does not even suggest the presence in this case of Question A.

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[1] See opinion of Judge Medina in *Hazard v. Furst*, 238 F. 2d 700 at 704 (2d Cir., 1956), affirming 140 F. Supp. 507, cert. den. 353 U. S. 937.

[2] 15 U. S. C., Secs. 80a-1 et seq.

## ARGUMENT.

### 1. Construction of the Investment Company Act of 1940 was not necessary to the decision by the Court of Appeals.

While the Court of Appeals appears to have rested its decision on the ground that the Investment Company Act of 1940 does not subject directors to "strict liability as insurers," its decision could equally well be sustained on the ground that the case **does not arise under** the laws of the United States.

The complaint in this case charges certain managing directors (who are distinct from the "outside"[3] directors, some of whom are respondents here) with having engaged in numerous violations of their fiduciary duties and with having profited handsomely thereby.[4] The "outside" directors, including respondents, are charged with having had actual or constructive knowledge of the insiders' misconduct, and with having "committed, or with actual or constructive knowledge, aided, abetted, acquiesced in or condoned"[2] violations of the Investment Company Act by the corporation.

Since the Court of Appeals could have found that the complaint states a cause of action against the outside directors **under state law**, this Court is faced squarely with the question whether the case is one arising under the laws of the United States. The reason why this question is presented is illustrated by **Howard v. Furst**, 238 F. 2d 790 (2d Cir., 1956), affirming 140 F. Supp. 507, cert. den. 353 U. S. 937, where a stockholder in Circle Wire & Cable Corporation complained of misleading statements made in

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[3] Paragraph 6 of Complaint (R. 3).

[4] The managing directors answered over without raising the question of jurisdiction.

[2] Paragraph 21 of Complaint (R. 6).

that corporation's proxy statement relating to a proposed sale of its assets and sought in a derivative action to invoke private rights under Section 14 (a) of the Securities Exchange Act of 1934[1] and the Commission's proxy rules issued thereunder. Judge Medina's opinion says in part (pp. 793-4):

> "We turn to the subject of jurisdiction over subject matter. For, if appellant's claim is presented in a case 'arising under' the laws of the United States, a dismissal for lack of jurisdiction is not warranted solely because the interpretation of the federal statue relied upon turns out to be wrong. Accordingly, we shall now examine the allegations of the complaint in order to determine whether, as found by the court below, appellant's claim is for violation of state-created rights, in no real or substantial sense dependent upon the provisions of the Securities Exchange Act of 1934 relative to proxy statements.
>
> "The controlling authority is Gully v. First National Bank in Meridian, 299 U. S. 109, 57 S. Ct. 96, 81 L. Ed. 70, where Mr. Justice Cardozo restates what had long been settled law, to the effect that the federal right relied upon must be an essential element of plaintiff's claim, that it must be of such a character that it will be supported if the federal law is given one construction or effect, and defeated if it receives another. He adds 299 U. S., at page 118, 57 S. Ct. at page 100:
>
> > "'As in problems of causation, so here in the search for the underlying law. If we follow the ascent far enough, countless claims of right can be discovered to have their source or their operative limits in the provisions of a federal statute

[1] 15 U. S. C., Sec. 78n.

> or in the Constitution itself with its circumambient restrictions upon legislative power. To set bounds to the pursuit, the courts have formulated the distinction between controversies that are basic and those that are collateral, between disputes that are necessary and those that are merely possible. We shall be lost in a maze if we put that compass by.'

"Applying this test it is clear to us that every essential element of appellant's case depends upon the common law and the statutes of the State of New York. If the individual defendants who controlled 60.68% of Circle's outstanding stock, in violation of their fiduciary duties as directors and officers of Circle, brought about a sale of Circle's assets for a grossly inadequate sum, all in furtherance of their personal and private interests, the case would be ripe for judgment for rescission of the sale or for damages, wholly irrespective of whether some or all of the individual defendants had participated in the formulation and sending out of a false or misleading proxy statement. The allegations with reference to the proxy statement constitute a mere excrescence or superfluity tacked onto what are otherwise sufficient allegations of a claim for relief under New York law.

"The controversy as to the interpretation to be given Section 14 (a) is, therefore, not basic but collateral to appellant's case."

From the foregoing it follows that:

The decision below is supportable independently of interpretation of the Investment Company Act of 1940.

If certiorari were granted for the purpose of settling the interpretation of the Investment Company Act of 1940, this Court might never reach that issue.

**2. The decision below was correct on the grounds stated by the Court of Appeals.**

The Securities Act of 1933,[1] the Securities Exchange Act of 1934,[2] and Sections 16 (a) and 17 (b) of the Public Utility Holding Company Act of 1935[3] each made **express provision** for private civil litigation. By contrast, the Investment Company Act of 1940[4] makes no such provision. In **Pennington v. Coxe**, 2 Cranch 33 (1804), Chief Justice Marshall said:[5]

> "Where the legislature distinguishes between different objects, and in imposing a duty on them evidences a will to charge them in different situations, it is not for the courts to beat down these distinctions on the allegation that they are capriciously made, and therefore to be disregarded. It is the duty of the court to discover the intention of the legislature, and to respect that intention. Where the provisions of two acts are so unlike each other, that the comparison exhibits only a contrast, instead of saying that their opposing regulations were designed to be similar, it would seem much more reasonable to say that the one act exhibits a legislative mind materially variant in the particulars where the difference exists from what is exhibited by the other."—2 Cranch at 59.

Moreover, it was not until 1941 (the year after adoption of the Investment Company Act) that any court saw fit to

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[1] 15 U. S. C., Secs. 77k, 77l, and 77o.

[2] 15 U. S. C., Secs. 78i (e), 78p (b), 78r (a), and 78t (a).

[3] 15 U. S. C., Secs. 79p (a) and 79q (b).

[4] 15 U. S. C., Secs. 80a-1 et seq.

[5] The case held that an excise tax on refined sugar became payable not when the sugar was refined but only when the refined sugar was shipped from the refinery. Chief Justice Marshall rejected the government's attempted analogy of the tax on distilled spirits, which became payable as of the time of distillation.

find in any of the federal securities laws an implied private right of action. Accordingly, in 1940 Congress could not have been mindful of any such interpretation of the earlier securities acts.

It may be conceded that the Investment Company Act was intended to protect both the public interest and the interest of investors. However, the regulatory scheme of the Act is primarily one of imposing restrictions on the activities of investment companies. The prohibitions which might have some application to directors (being phrased in terms of "no person . . .") are incidental to the main current of the statute. Drafting of the Act received long and expert attention from the staff of the Securities and Exchange Commission. Except for the prohibition in Section 80a-17 against self-dealing and authority given the SEC by Section 80a-35 to proceed against a director for gross abuse of trust, regulation of the conduct of directors was intentionally omitted. The Congress rejected the notion of any drastic revision of managerial responsibility. (See opinion below at Pet. Brief, p. 51). To find a civil remedy under these circumstances would be pure invention.[1]

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[1] As the Court of Appeals points out (Pet. Brief, p. 48, note 1), had Congress intended to authorize private civil actions against directors of investment companies, it could easily have followed the well traversed road of national bank legislation, which doesn't leave the matter to chance:

> 12 U. S. C., Sec. 93: "If the directors of any national banking association shall knowingly violate, or knowingly permit any officers . . . to violate any of the provisions of this chapter, all the rights, privileges, and franchises of the association shall be thereby forfeited . . . And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person shall have sustained in consequence of such violation."
>
> 12 U. S. C., Sec. 73: "Each director . . . shall take an oath that he will . . . diligently and honestly administer the affairs of such association, and will not knowingly violate or willingly permit to be violated any of the provisions of this chapter . . ."

3. **No important federal question is involved.**

This petition for certiorari does not present an important question of federal law calling for determination by this Court.

The Investment Company Act became law in 1940. Already at that time investment companies (mutual funds) constituted an important segment of the securities market. However, in two decades there has been relatively little litigation under the Investment Company Act.

The importance of a decision of this controversy by the Supreme Court should be measured by its consequences. As has been argued above, if certiorari were to be granted, this Court might well decide the case on a ground not involving interpretation of the Investment Company Act. However, even assuming that the Court would reach the issue of interpretation of that Act, what would the consequences of decision be?

If the decision below were to be reversed and federal jurisdiction were to be upheld, it will mean no more than that federal courts have concurrent jurisdiction with state courts for acts of directors which, even without this Act, would generally constitute violations of fiduciary duties under the common law of the several states, and that mutual funds would enjoy the convenience, and their directors be subjected to the inconvenience, of the "long arm" service of process provided for in the Act. On the other hand, if the decision below were to be affirmed and federal jurisdiction denied, as we think it should be, investment companies with rights of action against their directors for nonfeasance or malfeasance will be relegated to their wholly adequate remedies in the state courts.

4. **There is no conflict of decisions.**

The brief in opposition of Respondents' Brouk et al. adequately shows that the pretended conflict with **Goldstein v. Groesbeck**, 142 F. 2d 422 (2d Cir., 1944), does not exist.

Respectfully submitted,

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